

Traditional Compensation Plans Suck: More Cash, Less Equity => Better Motivation at Lower Cost

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The counterintuitive math: Pay MORE cash and LESS equity → employees capture more value, work harder, AND it costs you less. This isn't theory—it's 40 years of behavioral economics that boards ignore.

Ask yourself: is a 5-year-out payoff or a 20% bonus really going to make someone work till 2am every night, or make those annoying \$200 micro-optimizations 1000s of times that add up to millions? The answer is NO—and that's why most comp plans suck.

Who This Paper Is For

This paper is written for SaaS founders, CEOs, board members, and PE operating partners who suspect their compensation plans aren't actually motivating anyone—and want a framework grounded in behavioral economics rather than convention. If you've ever wondered why your LTIPs aren't driving the urgency you expected, or why a 15% bonus target hasn't changed how your team operates, the answer is in the math below. The framework is designed for software and SaaS businesses in the \$5-50M ARR range, but the underlying principles apply to any company paying executives with a mix of cash and deferred compensation.

Executive Summary

Conventional comp plans fail because they ignore how humans value money. Boards grant LTIPs and equity believing they're "aligning incentives," but behavioral economics shows employees discount deferred, uncertain compensation at ~50%/year—far above the 8-10% boards assume. A \$300K LTIP vesting over five years is perceived as ~\$47K. The company pays \$300K but captures only 16% in motivation. That's 84% leakage.

Compounding this: most variable comp is too small to matter. Bonuses below 50% of base rarely change behavior—the effort isn't worth the payoff. Most plans offer 10-20% and wonder why nothing changes. Worse, capped bonuses create diminishing returns: why push harder once you've hit the ceiling? Elite funds like Citadel never cap—within risk and governance limits, they never want to dissuade you from creating more value.

This paper proposes a framework built on behavioral economics first principles: base at market +5-25% (by level), executives get 80% of base as annual cash bonus tied to ARR growth, EBITDA margin, NRR, and

durability. No LTIP. Higher base compensates for no equity; large cash bonus drives daily motivation.

Result: total comp costs drop ~11%, employees perceive ~20% more value, incentives actually change behavior, and the plan is simple to administer. Everyone wins.

What Makes a Comp Plan Work—And Why Most Fail

A good comp plan should:^[1]

1. Change employee behaviors in a way that they create more value for the company
2. Be implementable at scale (i.e., should not have significant implementation overhead)
3. Fit cash flow (i.e., not require payouts that do not exist)

Most plans nail #3 (LTIPs are great for cash flow!) while failing #1, which is the most important at actually creating value. Why? Boards misunderstand how humans value compensation:

- **Time discounting is ~33%/year**—not the 8% from Econ 101. \$100 today = \$133 guaranteed in 1 year.^[6]
- **Risk discounting adds another ~16%/year**—risky future comp is discounted ~50%/year total.^[3]
- **Discounting is hyperbolic**—each subsequent year is discounted at a lower rate (steeper near-term, flatter long-term).^[7]
- **Most incentives are too small anyway**—a \$50K bonus won't change how hard a \$300K CEO works.^[12]

These are well-established findings from Kahneman/Tversky (prospect theory),^[2] Thaler (mental accounting),^[4] and Laibson (hyperbolic discounting).^[5] Pepper synthesized them into a practical framework showing boards how much value they're destroying.

Here's what all that behavioral economics actually means in practice for a typical PE compensation plan

	Maximum Value	Perceived Value from Management	Actual Payout (assume 75% of target)
Salary	\$1,000,000	\$1,000,000	\$1,000,000
Bonus (paid in 1y)	\$350,000	\$234,899	\$262,500
As % of Salary	35%	23%	26%
Cumulative Long Term Equity Comp (paid in 5y)	\$5,000,000	\$780,806	\$3,750,000
Amortized Long Term Equity Comp (over 5 y)	\$1,000,000	\$156,161	\$750,000
As % of Salary	100%	16%	75%
Total Annual Compensation	\$2,350,000	\$1,391,061	\$2,012,500
Total Variable Compensation	\$1,350,000	\$391,061	\$1,012,500
As % of Salary	135.0%	39.1%	101.3%
Discount factor on bonus (1 year risk + time @ 16%+33%)		0.671	
Discount factor on LT Equity Comp (5 years risk & time, 49%, 47%, 45%, 43%, 41%)		0.156	

Figure 1: What a Traditional Compensation Scheme Looks Like from a CEO's Point of View vs. the Board's

Two core problems:

1. Incentive comp is only 30-40% of perceived value—too small to change behavior^[13]
2. Company pays for comp that doesn't benefit management or motivate behavior—everyone loses^[9]

A Fundamentally Better Compensation Framework

Design constraints:

- Variable comp must be 50-100%+ of base to change behavior—10-20% bonuses don't matter.^[20]
- One usable framework across the company, easily calculated metrics from standard financials.^[11]

The framework: Two layers, no LTIPs, no phantom equity.

- **Generous Base:** 25-50% above market (compensates for no LTIP)
- **Annual Cash Bonus:** 75-100% of base for executives, quarterly accrual, enough to change behavior

The Compensation Framework (SaaS-Specific)

Goal: Drive SaaS value-creating outcomes—ARR growth, gross and net retention, customer durability, and EBITDA margins.

How to Achieve It

Level	Base	Variable Comp
IC (Non-Sales)	Market + 5%	No bonus
IC (Sales/Quota)	Market rate	Commission at 10% of new ARR
Manager	Market + 10%	No bonus
Executive	Market + 25%	80% of base, tied to company metrics

The Math: Proposed Plan vs. Conventional Plan for an Illustrative \$10M / 50 FTE SaaS Company

Group	Conventional Comp Plan			Proposed Framework		
	Cash Cost	Total Cost	Perceived Value	Cash Cost	Total Cost	Perceived Value
ICs (40)	\$3.44M	\$3.44M	\$3.36M	\$3.36M	\$3.36M	\$3.36M
Managers (7)	\$966K	\$966K	\$925K	\$924K	\$924K	\$924K
Executives (3)	\$825K	\$1.73M	\$892K	\$1.20M	\$1.20M	\$1.05M
Totals	\$5.23M	\$6.13M	\$5.18M	\$5.48M	\$5.48M	\$5.34M
Net Benefit vs. Conventional	—	—	—	+\$253K	-\$647K	+\$159K

Per-person breakdown: Conventional: ICs \$86K (\$80K + \$6K bonus), Managers \$138K (\$120K + \$18K bonus), Execs \$575K (\$200K + \$75K bonus + \$300K LTIP). Proposed: ICs \$84K (mkt+5%, no bonus), Managers \$132K (mkt+10%, no bonus), Execs \$400K (\$250K + \$150K bonus, no LTIP).

Perceived value discounts: Base = 100%. Cash bonus = 67% (1-year delay). LTIP = 15.6% (5-year vesting). A \$300K LTIP costs \$300K but exec perceives only \$47K—this is the core inefficiency.^{[14][15]}

Executive Bonus Metrics (SaaS)

Metric	Weight	Definition
ARR Growth	30%	YoY organic ARR growth (excluding acquired ARR)
EBITDA Margin	25%	EBITDA / Revenue, normalized for one-time items
Net Revenue Retention	20%	$(\text{Starting ARR} + \text{Expansion} - \text{Contraction} - \text{Churn}) / \text{Starting ARR}$
Durability Score	25%	Composite: GRR >85%, customer concentration, CAC payback <18mo, logo retention, employee retention >85%

If It's So Simple, Why Isn't Everyone Doing This?

Ignorance: These findings don't make it into MBA curricula. At HBS, my Organizational Management course spent zero time on behavioral economics. The standard MBA teaches WACC discounting and assumes everyone else discounts the same way.

Status quo bias: "Nobody ever got fired for doing what everyone else does." Proposing a departure from norms creates career risk—if it fails, you're the one who pushed the weird comp plan.^[8]

Misaligned consultants: Comp consultants get paid to benchmark against peers, not redesign from first principles. Simple frameworks don't require \$500K engagements.^[16]

Optics (and habits) trump economics—a personal example

I once proposed to a PE firm: "give management 50% of incremental EBITDA growth." At 16x EBITDA, each \$1 of growth meant 50¢ to management and \$16.50 to equity holders—3,300% ROI. They refused. Not because the math didn't work—it was positive ROI in every scenario. They refused because "high" cash bonuses weren't what they were used to. Optics beat economics.

The opportunity: This is precisely why getting comp right is a competitive advantage. Firms that adopt this framework can attract better talent at lower cost while competitors stay stuck.

What Comp Can't (and Shouldn't) Solve

A common mistake in compensation design is trying to incentivize leadership development, professional development, and governance through bonuses. These are important—but they're squishy metrics companies love to pretend they're measuring. "Developed 2 leaders this year" is unfalsifiable nonsense. Worse, tying bonuses to soft goals backfires—external rewards crowd out intrinsic motivation.^{[18][19]} Here's how to actually address them:

Leadership development: Give internal candidates first shot at openings—they already know the business. Let teams operate with real autonomy rather than layering on bureaucracy. Conglomerate behavior (endless admin, cross-team coordination theater) wastes time and worsens performance.

Governance: Governance, ethics, and behavior are hiring/firing criteria, not bonus criteria. You don't get extra pay for following the rules.

Professional development: Create visible career paths and maintain transparency so people can volunteer for stretch assignments. If someone wants to work 50 extra hours to ship a critical feature or close a key deal, never stop them—that's development happening organically.

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